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MONDAY, MARCH 14, 1988

Telephony

INTEGRATING VOICE AND DATA COMMUNICATIONS

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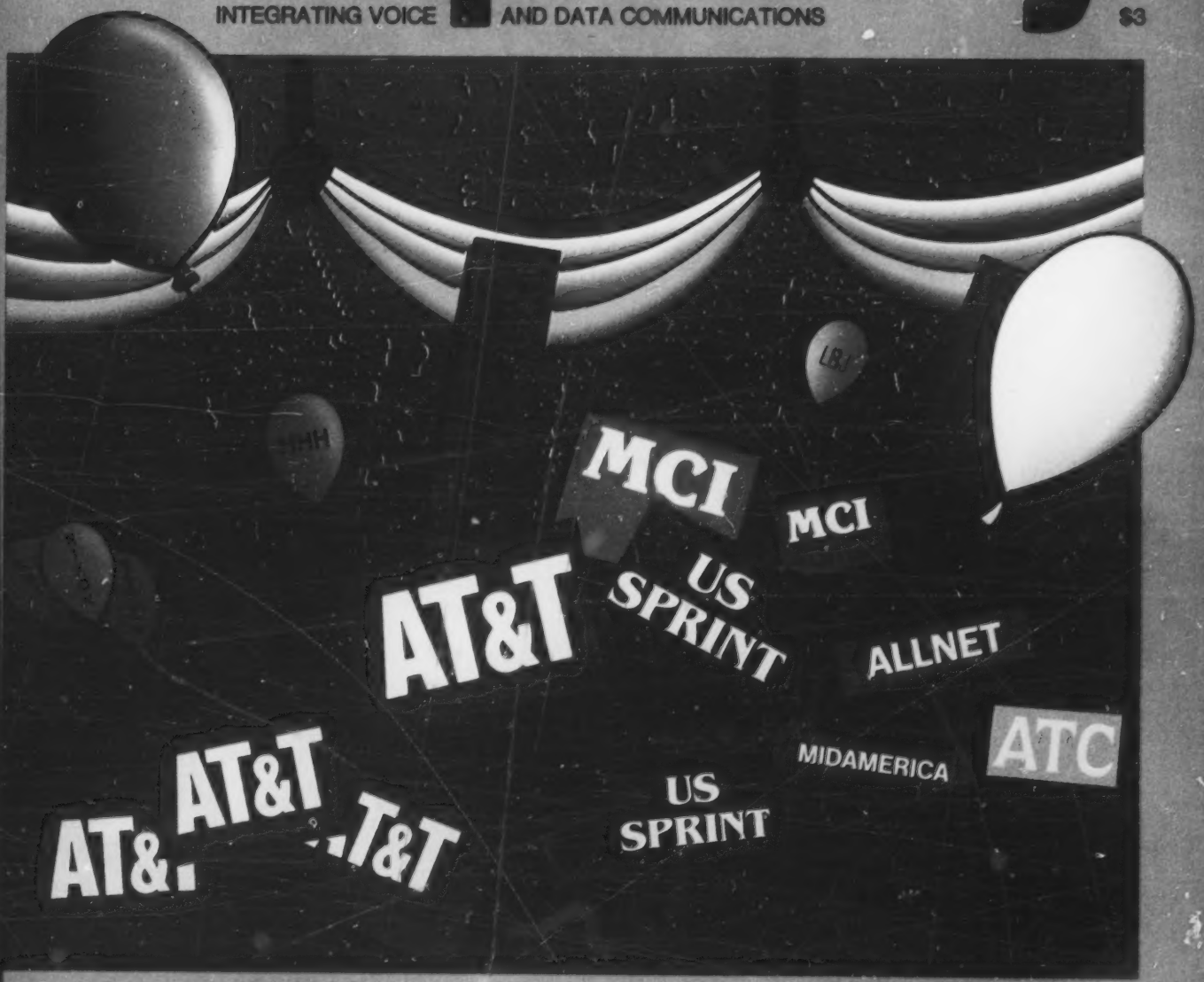

IXCs CAMPAIGN FOR SHARE IN '88

The top three IXCs have lofty goals for a winning ticket

LIGHTS UP ON INFORMATION SERVICES

Greene lets the RHCs into transmission, voice messaging

THE RHCs ARE READY —BUT IS THE MARKET?

With technology at hand, they must develop demand

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MONDAY, MARCH 14, 1988 Volume 214, No. 11

Telephony

INTEGRATING VOICE AND DATA COMMUNICATIONS

The undisputed top three IXCs—AT&T, MCI and US Sprint—have entered the 1988 election year campaigning for market share. Cover art by AGS&R

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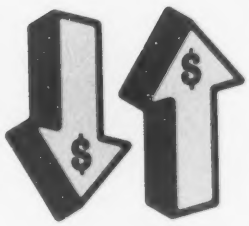
LEC earnings reflect surprising range of results



A look at earnings by the RHCs and top three Independents for the first and fourth quarters of 1987 shows the majority are continually building their economic base

SUSAN UBIS, Staff Editor

The earnings results are in and the figures have been tallied. The general picture is that 1987 was a lopsided year for local exchange carriers.

Table 1 tells the numbers story. Of the Bell regional holding companies, Pacific Telesis was the big loser, showing a 48.8% drop in earnings for the fourth quarter, compared with the first quarter. Bell Atlantic and BellSouth posted drops in earnings between the first and fourth quarters, of 7.3% and 9%, respectively (Table 2).

On the up-side, U S West was the biggest gainer, showing an increase in net income of 24.9% between the first and fourth quarters. Ameritech, Nynex and Southwestern Bell also rallied for a better fourth quarter showing.

The three major Independents also showed mixed results. GTE and United Telecommunications showed improvements, attributed to efficiencies in their joint US Sprint long-distance unit. But Contel recorded a 271.5% deficit between the first and fourth quarters, taking substantial writeoffs for its Contel ASC unit and other assets.

TABLE 1 EARNINGS COMPARED— 1ST QUARTER AND 4TH QUARTER 1987

	net income ($000,000)	revenues ($000,000)	earnings per share
Ameritech			
4th quarter	322.2	2447	$2.33
1st quarter	289	2300	2.03
Bell Atlantic			
4th quarter	285	2603	1.44
1st quarter	307.5	2465	1.54
BellSouth			
4th quarter	411.5	3167	.85
1st quarter	452.4	2950	.94
Contel			
4th quarter	(93.8)	807	(1.21)
1st quarter	54.7	723	.71
GTE			
4th quarter	334	4074	.99
1st quarter	265	3693	.78
Nynex			
4th quarter	322.5	3103	1.59
1st quarter	299.2	2891	1.47
Pacific Telesis			
4th quarter	150	2415	.35
1st quarter	293.3	2244	.55
Southwestern Bell			
4th quarter	246.5	2152	.82
1st quarter	237.7	1876	2.37
United Telecommunications			
4th quarter	29.1	792	.29
1st quarter	13.5	720	.13
U S West			
4th quarter	255	2163	1.35
1st quarter	204.2	2040	1.08

Beneath the Surface

The numbers don't tell the whole story. Between writeoffs, restated figures and stock splits, there is much left between the lines of those financial statements.

Ameritech's gains can be attributed to the performance of its Enterprise Group, which accounted for more than half of Ameritech's net income for 1987. Fourth quarter results were also affected by lower state and federal income taxes.

Bell Atlantic showed increases in revenues, but also posted sizable increases in expenses, including employee benefits, depreciation and amortization. Still, earnings for both the first and fourth

quarters of 1987 were higher than similar periods in 1986.

BellSouth had a very strong year, despite its drop in earnings between the first and fourth quarters. The company posted its best-ever gain in access lines, adding 656,000 access lines for the year. While revenues increased, those figures were offset somewhat by increased depreciation expenses. Still, earnings figures improved in both periods compared to the same periods for 1986.

Contel shifted several operations in the fourth quarter, resulting in its $93.8 million net loss. Among the changes were the sale of its Texocom telephone supply business to Alltel Supply Co. That transaction alone brought a write-off of $11 million for the fourth quarter.

Contel's Telephone Operations Sector posted its strongest annual financial results in the company's history. The increases were due in part to revenues from the recently deregulated inside wiring maintenance fees, and billing and collection services for interexchange carriers.

Contel Cellular also improved throughout the year, doubling its customer base and expanding into six new markets. Despite the strong showing, Contel decided to put a hold on a stock offering after the stock market tumble last October.

The Information Systems Sector posted a $127 million loss, due to the company's decision to revamp Contel ASC. In addition, Contel agreed to sell its Executone division to Vodavi Technology Corp.

GTE's fourth quarter gains can be attributed to three actions. Among those are gains realized on pension settlements and the sale of real estate holdings.

Also, US Sprint, which GTE owns jointly with United Telecom, posted its best quarter ever, with each company losing only $58 million, compared to $121 million in the first quarter. Sprint's improvements are due to its conversion to a fiber optic network, which reduced the company's costs for its microwave network and for leasing capacity on other networks. A crackdown on fraudulent users of the network also left a positive mark.

TABLE 2 EARNINGS CHANGE— 1ST QUARTER TO 4TH QUARTER 1987

	dollars ($000,000)	percentage change
Ameritech	33.2	+ 11.5
Bell Atlantic	(22.5)	− 7.3
BellSouth	(40.9)	− 9
Contel	(148.5)	−271.5
GTE	69	+ 26
Nynex	23.3	+ 7.8
Pacific Telesis	(143.3)	− 48.8
Southwestern Bell	8.8	+ 3.7
United Telecommunications	15.6	+115.5
U S West	50.8	+ 24.9

GTE's three main units—Telephone Operations, Electrical Products and Communications Products—also posted higher revenues in the fourth quarter, compared to the first quarter. But Telephone Operations had lower income in the fourth quarter. The decrease reflects the company's effort to offset increased capital recovery and other costs by lower income tax rates and pension costs.

Electrical Products had a much better fourth quarter because of higher shipments of lighting products and precision materials, as well as favorable foreign exchange rates. The increase also reflects higher sales and lower pension costs.

Nynex had a good year. Increases in customer lines and digital lines contributed to higher earnings, as well as network upgrades. First quarter earnings were offset somewhat by costs for staffing and training, as well as costs associated with the establishment of a research and development organization.

Three factors contributed to Pacific Telesis' decrease in earnings for the fourth quarter. The company implemented an early retirement program, which increased expenses for the quarter by $217 million. PacTel Communications was restructured, which included closing some PacTel Info Systems stores.

The company also felt the effects of a California Public Utilities Commission rate case reversal, and restated earlier earnings per share values because of it. First quarter earnings, restated to reflect a two-for-one stock split, were restated again to reflect the rate refund, to 55¢.

Economic conditions in Southwestern Bell's territory have adversely affected company performance in the last few years. Although access line growth was flat, the company reaped greater returns as 1987 progressed. A three-for-one stock split in May altered the earnings per share picture. Fourth quarter earnings were affected by Southwestern Bell's purchase of Metromedia Paging Services.

US Sprint's performance brightened United Telecom's earnings picture. Improvement in the telephone operations' performance also played a part. Revenues in that unit increased 6% for the year, while income rose 4%. The number of access lines grew 4.2% for the year.

U S West's first quarter results were reduced by $23.6 million by a career incentive plan, which cut 1400 managers. The costs related to a ruling by the Oregon Public Utility Commission to refund $6.6 million were tacked on to first quarter earnings also.

U S West's non-regulated subsidiaries showed a profit for the first time in 1987, enhancing the fourth quarter results.

All the companies expect efficiencies and improvements made in 1987, whether depreciation expenses, retirement programs, acquisitions or mergers, will improve their bottom lines in 1988. With first quarter earnings due in the next month, the proof will be in the pudding. ■

Interexchange carriers campaign for market share in '88

ELLIS BOOKER, Features Editor, and CZATDANA INAN, Marketing Development and Research Director

Last March, *Telephony's* survey of the interexchange marketplace revealed a continuing battle for survival among those IXCs below market leaders AT&T Communications, MCI Communications Corp. and US Sprint Communications Co. Although these "second tier" companies occupied just 6.1% of the total $28.1 billion 1987 interexchange business, some of the most dramatic events in the industry occurred in this segment.

Meanwhile, the undisputed top three IXCs—AT&T, MCI and US Sprint—have entered the 1988 election year with goals not unlike those of the presidential hopefuls: Avoid embarrassing mistakes and offer a consistent, public image through advertising. (For a closer look at how AT&T, MCI and US Sprint conduct their advertising, see story on page 30.)

The charts on the following pages are the product of *Telephony's* Market Research Department.

Methodology

This report is based on exclusive primary research conducted by *Telephony's* Market Research Department between January and February this year.

Each of the interexchange carriers was queried on its customer base, sales, the composition of its sales force and number of employees. In addition, the companies were asked to report all acquisitions made during the past two years.

Any estimates that appear in this report have been cross-checked by *Telephony's* Market Research Department against filings by the IXCs with the Federal Communications Commission, the Securities and Exchange Commission and the *Telephony* Market Research Department database and are believed to be accurate within ± 5% of the estimated amounts.

Dominant Three

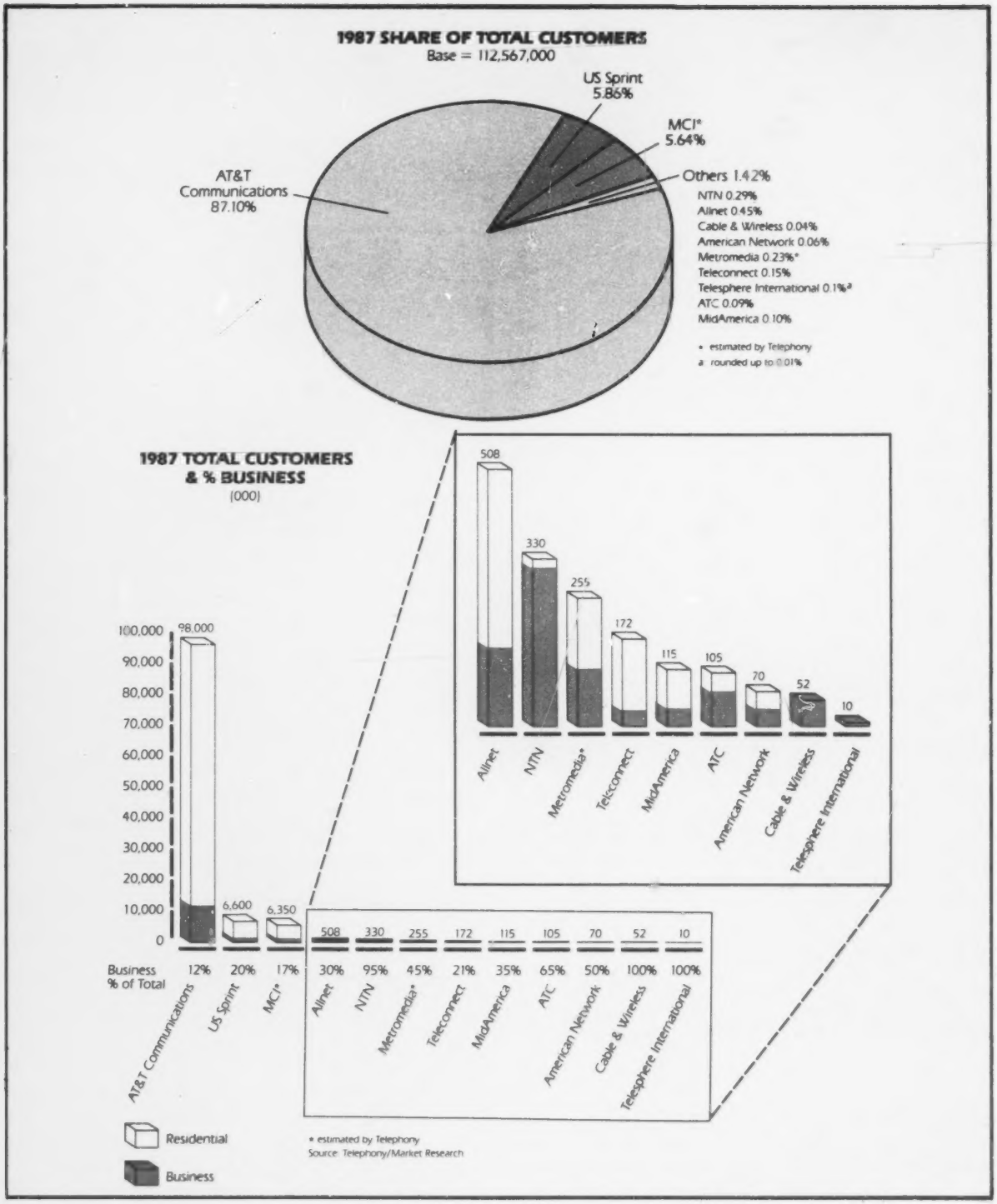
As expected, AT&T, MCI and US Sprint own the lion's share of the industry, both in terms of revenues and total customers (see accompanying tables). Of total industry revenues, AT&T had 69.9% of the market, MCI 14% and Sprint 10%.

Actual net revenues for the industry moved from $26.04 billion to $28.13 billion between 1986 and 1987, or an 8% increase. Of this, AT&T topped the scales at $19.66 billion, a 2.9% change over 1986, and MCI came in second with $3.94 billion, a 9.7% change over 1986.

But the big revenue story in the '86-'87 period was Sprint's performance. This IXC, the result of a 1986 merger between the faltering long-distance operations of GTE Corp. and United Telecomunications, had net revenues of $2.8 billion in 1987, a massive 45.8% gain over its 1986 showing of $1.9 billion.

Even so, Sprint and MCI were neck-and-neck in customer growth for the period, each showing a 27% gain compared to AT&T's 2% increase. Interestingly, the business-to-residential ratio held rock steady at all three companies.

Below the top three IXCs, Allnet Communication Services Inc. held 0.45% of the IXC industry by total customers in 1987. Allnet was followed by the National Telecommunications Network, or NTN, with 0.29%. But NTN, a partnership of five regional IXCs, actually outperformed Allnet in terms of reve-

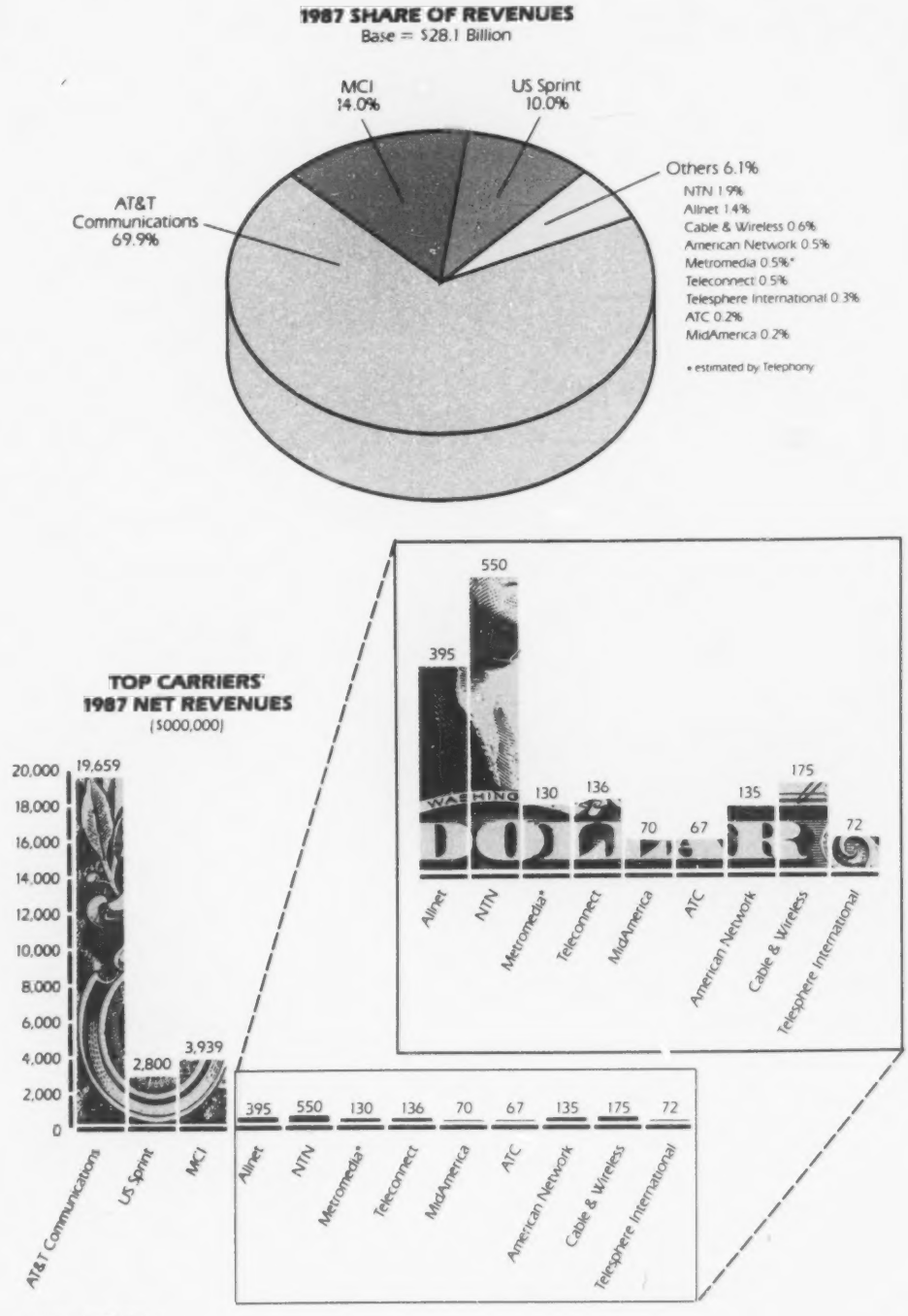


nues and customer growth, posting $550 million in 1987 to Allnet's $395 million, and increasing its customer base by 65%.

In fact, NTN's revenue gain in 1986-87 was a whopping 83.3%, making it far and away the industry leader on this measure among the top 11 IXCs. In comparison, Allnet's revenues fell 12.2% during the period, a change the company attributes to its rate cuts in response to AT&T's rate cuts. This difference may reflect the business-to-residential ratio at each company: Thirty percent of Allnet's customers are business compared to 95% at NTN.

But consolidation and merger, not financial performance, were the watch words for the second tier companies. NTN, for instance, began 1987 with seven companies in its consortium, but ended the year with five. First, Williams Telecommunications Co. and LDX Net Inc. agreed to merge *(Telephony, June 22, 1987, page 12)*. In August, on the heels of that consol-

continued on page 27


1987 SHARE OF REVENUES
Base = $28.1 Billion
MCI 14.0%
US Sprint 10.0%
Others 6.1%
NTN 1.9%
Allnet 1.4%
Cable & Wireless 0.6%
American Network 0.5%
Metromedia 0.5%*
Teleconnect 0.5%
Telesphere International 0.3%
ATC 0.2%
MidAmerica 0.2%
* estimated by Telephony
AT&T Communications 69.9%
TOP CARRIERS' 1987 NET REVENUES
($000,000)
20,000
18,000
16,000
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
19,659
2,800
3,939
AT&T Communications
US Sprint
MCI
395
550
130
136
70
67
135
175
72
Allnet
NTN
Metromedia*
Teleconnect
MidAmerica
ATC
American Network
Cable & Wireless
Telesphere International
* estimated by Telephony
Source: Telephony/Market Research

idation, Southland Communications Corp. agreed to become part of NTN member SouthernNet Inc.

"I think five is a good number for the short-term . . . for '88," says NTN Vice President and General Manager Martin F. McDermott, who at last seems comfortable with the idea that future consolidation within the NTN group is a possibility. McDermott insists, however, that these changes will probably involve geographically contiguous NTN companies, not outsiders.

But stemming the tide of second tier consolidations or dictating their nature may prove difficult. Late last month, NTN member Microtel Inc. announced an agreement, in principle, to become a subsidiary of Advanced Telecommunications Corp. (see sidebar).

Regional Viability

Interestingly, despite abundant evidence that the shakeout among second-tier IXCs will continue, executives from these companies continue to argue the viability of a "regionalized" approach.

Charles H. Helein, general counsel for the Alternative Carrier Telecommunications Association, admits that making a small IXC work is a matter of marketing, location, management and, most important of all, customer service.

"We have to compete on customer service and *innovative customer service*," says Helein, whose three-year-old association has about 50 small, second-tier IXC members.

Helein tells of one of the association's members who enjoys profits "despite lost margins" simply because of manic attentiveness to his customer's bills.

"If he sees an unusual traffic increase, he gets in touch with the customer right away," reports Helein. (Indeed, asked about the key business concern for his members, Helein answers, without hesitation, "fraud." The association currently is investigating possibilities for "fraud insurance" for its members.) But ancillary services beyond billing, such as 800 numbers, operator assistance and international service, present a thorny problem for small IXCs, according to Helein.

"Take operator service. It's both an opportunity and a threat. If other [IXCs] offer it, you may potentially lose business to them." The question, he continues, is whether the margin exists to justify the expense of offering these services. He concludes that some companies may be pressed to offer such services in order to appear competitive, even if the services themselves contribute very little revenue.

Regulatory Outlook

Unquestionably, the most significant regulatory event in the IXC industry this year will be the resolution of the Federal Communications Commission's proposal to replace AT&T's rate-of-return regulation with some form of price-cap regulation.

However, the impact that this will have on the industry (and AT&T's earnings potential) depends on the specific provisions of the price-cap plan, according to Audrey Stevoff, vice president, Duff and Phelps Inc.

"There's been talk about an up-front price cut . . . an agreed upon price cut," says Stevoff, whose sources inside the FCC say the commission will issue its order on the matter in April.

A second key issue, she says, is whether AT&T will be allowed to keep earnings above some agreed upon "productivity factor" or whether it will be told to pass these profits on to its customers in the form of rate reductions. Depending on its formula, a price cap could have a dramatic impact on MCI and US Sprint, Stevoff says.

Given the consolidations in the industry to date, and the prospect of more mergers and acquisitions to come, is there still a place for the "regional" IXCs?

Like some other second-tier IXC executives, NTN's McDermott praises the regional approach, which he says allows each NTN member company to "keep its arms" around the business. "It's like the interconnects in the old days. It's hard to be in the middle. You can be a very large company or very small," he comments.

This view is shared by analyst Stevoff. "There's still a place for small companies. Texas once had 200 [alternative carriers]," she notes, adding that in locations not served by MCI or Sprint, a smaller IXC could offer customers service and price for toll calling that could be more attractive than AT&T's offerings. T

Latest two mergers

As if to underscore the ongoing consolidation among interexchange carriers below the dominant top three companies, four IXCs entered into agreements during the week *Telephony's* survey story was being prepared.

On Feb. 26, MicroTel, a fiber carrier in Florida, agreed to become a subsidiary of Atlanta-based Advanced Telecommunications Corp. Under the deal, MicroTel shareholders would exchange common shares of stock for ATC shares.

MicroTel is one of five companies in the National Telecommunications Network partnership, a group of regional, fiber-based IXCs, and is 45% owned by Alltel Corp., the nation's fourth largest IXC concern.

In a second merger story, Vancouver, Wash.-based American Network Inc. agreed Feb. 25 to be purchased by United States Transmission Systems Inc., the long-distance subsidiary of ITT Corp., for approximately $2.2 million. With 70,000 customers, American Network posted 1987 revenues of $135 million.

ITT's original bid to take American Network was called off late last year *(Telephony, Dec. 14, 1987, page 26)*. American Network had been the target of a lawsuit by its investors. Although ITT had made dismissal resolution of the litigation a condition of the sale, it waived this condition in its recent bid.

Speaking to *Telephony* a few days after the second ITT deal was announced, John Beeby, director of marketing at American Network, said he expected the IXC industry would consolidate to "four or five players."

An ITT spokesman confirmed that, if the acquisition meets with shareholder and regulatory approval, American Network will be fully folded into United States Transmission Systems.